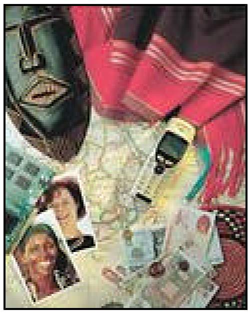

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International Trade and Poverty Alleviation

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How does trade liberalization affect the poor, and how can they be protected against its negative short-term effects?

Trade reform has long been part of the arsenal of policies used to promote economic efficiency, the development of new markets, and growth. Perhaps surprisingly, even after more than fifty years of trade negotiations, there is still significant protection in the world economy and thus scope for further benefits once protection is removed. Protection persists because it is a convenient and nontransparent way for governments to direct economic benefits to particular groups. Although trade liberalization raises the average standard of living in the medium term, groups that had been favored by protection will see their incomes decline, and the resulting restructuring of the economy may create economic dislocations in the short term.

There is increasing awareness that some of those who lose from trade reform might be the poorest members of society, who have fewer assets to draw on to protect themselves during hard times, and are thus less able to absorb adjustment costs, than their fellow citizens. Even a transitory loss of income can cause the poor to lose opportunities to acquire human capital through education, health care, and better nutrition and thus can reduce their chances of escaping poverty. The vulnerability of the poor justifies looking more carefully at the effects of trade liberalization on the poor and asking whether trade liberalization can be designed to minimize its negative effects.

Liberalization's effects

Trade liberalization can affect the welfare of the poor by

- changing the prices of tradable goods and improving access to new products;
- changing the relative wages of skilled and unskilled labor and the cost of capital, thereby affecting the employment of the poor;
- affecting government revenue from trade taxes and thus the government's ability to finance programs for the poor;
- changing incentives for investment and innovation and affecting economic growth; and
- affecting the vulnerability of an economy to negative external shocks.

Prices and availability of products. Trade liberalization helps the poor in the same way it helps most others, by lowering prices of imports and keeping prices of substitutes for imported goods low, thus increasing people's real incomes. Imported products that might be especially important for the poor include basic foods, pharmaceuticals and other medical or basic health products, and used clothing. The poor may also benefit significantly from removal of export taxes or prohibitions, to the extent that the poor are net producers of exports (as is often true in agriculture). An open trade regime also permits imports of technologies and processes that can help the poor—for example, packaging for perishable foods that is light and does not require refrigeration, chemicals for sterilizing water, and improved seeds and fertilizers. An example of trade liberalization resulting in tangible and immediate benefits for the poor is the African Summit to Roll Back Malaria, held in April 2000, at which the continent's heads of state pledged to reduce or waive taxes and tariffs for mosquito nets, insecticides, antimalarial drugs, and other goods and services needed for malaria control. There is also some evidence that liberalizing imports of used clothing can improve the welfare of the poor.

Wages and employment. Trade theory predicts how trade liberalization will affect wages and employment under very specific conditions. In practice, these conditions do not often hold, and for a more general analysis, we have to rely on empirical studies. These suggest at least two factors that will directly affect the way trade liberalization can change the wages and employment of the poor. First, how flexible labor markets are will determine whether the effects of trade reform translate into changes in employment or wages. If firms are constrained by labor regulations from reducing their workforces, most of the adjustment to changes in relative prices of outputs will be reflected in changes in real wages. If minimum wage legislation prohibits downward adjustments in wages but labor mobility is high, however, adjustment will take place through changes in employment.

In the rural and informal urban sectors (the informal sector is the part of an economy where businesses are not incorporated or otherwise registered with governments) of developing countries where the poor live, labor markets usually are highly flexible (being generally unregulated) and are characterized by a high elasticity of supply for labor. Wages will generally be determined by the requirements of urban and rural subsistence or the next-best employment opportunities that are available. Thus, we can expect that adjustment to trade shocks will take place predominantly through changes in employment. In this case, the costs of trade reform for the poor may be large, and government assistance may be required to mitigate their impact.

Second, the initial pattern of protection will have an important bearing on who wins and who loses when that protection is removed. If the pattern favors unskilled workers in agriculture and light manufacturing, as was true for Mexico in the early 1980s, then the removal of protection could be expected to lower the relative wages of these segments of the labor force.

Government revenues and programs for the poor. There is a general concern that trade reform may lead to lower government revenues as trade taxes are reduced and that, in an effort to maintain macroeconomic stability, governments may cut social expenditures or implement new taxes that could disproportionately affect the poor. At the initial stages of trade liberalization, however, replacing nontariff barriers with tariffs and eliminating tariff exemptions will generally increase government revenues. Similarly, if initial tariffs are prohibitively high, reducing them can result in higher trade flows, which will increase revenues. Lowering high tariffs also reduces incentives for smuggling and corruption, which, in turn, can increase the volume of goods recorded at customs and boost revenues. Finally, simplifying the tariff regime to create a more uniform structure, with just a few tariff rates, could increase fiscal revenue by increasing transparency and simplifying tax administration. In the latter stages of reform, however, lowering tariffs may lead to lower government revenues. In this instance, domestic tax reform (particularly the introduction of broader-based and less distortionary taxes) or expenditure restraint that may be required to maintain macroeconomic stability should be designed to minimize their adverse effects on the poor.

Investment, innovation, and growth. An important consideration in sustained poverty reduction is whether the country is experiencing robust economic growth in which the poor can participate. One of the main channels through which trade reform affects growth is by reducing the anti-export bias of trade policy and leading to a more efficient allocation of resources. However, this is a onetime gain in allocative efficiency and need not affect the economy's long-term growth rate. In the long term, trade liberalization can affect the economy's rate of growth by creating incentives for investment. In addition, trade reform usually encourages foreign direct investment, with attendant spillovers of advanced technologies and new business practices that increase overall productivity and growth in domestic firms.

Recent empirical research (for example, Rodriguez and Rodrik, 1999) suggests that the relationship between trade liberalization and growth is not straightforward. In particular, the effects of trade reform on growth depend upon the existence of other, complementary macroeconomic and structural policies and the creation of appropriate institutions. For example, in cross-country research, one variable that is consistently related to the rate of growth is the parallel-market premium on the exchange rate, indicating that exchange rate overvaluation may be an important inhibitor of growth. The implication is that undertaking trade reform without implementing appropriate macroeconomic and exchange rate policies (to improve competitiveness) will be less effective in promoting growth. Thus, a consistent overall economic package is essential if trade reform and other structural measures are to succeed in fostering adjustment and growth.

Even when liberalization leads to growth, one concern often raised is that open trade policies may lead to a pattern of growth that disproportionately benefits the rich, thus worsening the country's distribution of income. Recent evidence (see, for example, Dollar and Kraay, 2001), however, casts doubt on this assessment.

Vulnerability to negative external shocks. Trade liberalization will make an economy more open and deepen its economic integration with the rest of the world. In many cases, this will help an economy to diversify its exports in line with its comparative advantages and to become less dependent on single export markets or products. In addition, integration with foreign markets helps an economy become less dependent on the domestic market, so that domestic economic downturns are offset by growth in the international economy. Openness may, however, also make an economy more vulnerable to external shocks, such as abrupt changes in the terms of trade, that can significantly reduce growth. If the shocks directly affect certain sectors, such as agriculture or informal production, they can have significant effects on the poor.

Findings of empirical studies

Because of the complexity of the linkages between trade reform and poverty, the empirical evidence on trade liberalization and poverty is limited largely to case studies. Some studies use computable-general-equilibrium (CGE) models to trace the effects of trade reform on the poor.

Winters (2000) reports on a joint Oxfam-Institute of Development Studies study of liberalization of the cotton market in Zimbabwe during the late 1980s and 1990s that illustrates the potential effects of liberalization on the poor. Before liberalization, the government was a monopsony buyer (a sole buyer facing many sellers) of cotton from farmers and used low producer prices to subsidize inputs into the textile industry, thereby reducing the incomes of small, poor farmers. Liberalization included elimination of price controls and privatization of the marketing board. The results were higher prices and greater competition among three principal buyers, not only on price but also in providing extension and input services to small landholders.

In Zambia, liberalization of the maize market had the opposite result. Before liberalization, maize producers enjoyed cross-subsidies, financed by the mining sector, that considerably lowered the cost of inputs. In addition, small producers in remote areas were implicitly subsidized by prices, set by a parastatal firm (one funded by the government without formally being a part of it) serving as monopsony buyer, that were uniform for all seasons and throughout the country. When the subsidies were removed and the parastatal was privatized, larger farmers close to national markets saw no effective change in market conditions while small farmers, and especially those in remote areas, were severely affected by price fluctuations. In addition, owing to a sharp deterioration in transportation infrastructure, remote rural markets for corn completely disappeared, leaving poor farmers without formal incomes.

These episodes provide examples of the effects of different types of liberalization. In Zimbabwe, initial restrictions were analogous to a tax on exports that kept producer prices low and inhibited competition. The removal of these "taxes" resulted in benefits to net suppliers of exports. In Zambia, however, the restrictions were analogous to a tariff on imports that results in a subsidy being provided to domestic producers (and a tax on consumers) of import-competing products. The removal of the tariff/subsidy resulted in a decline in revenue for producers of the import-competing products and, at the extreme, the disappearance of uncompetitive domestic production. A more important distinction between these two cases, as Winters points out, is that in Zimbabwe liberalization resulted in the creation of markets in which the poor could participate and an improvement in market performance, while in Zambia it resulted in the disappearance of functioning markets for the poor's produce.

In general, this study and others have found that, in most cases, trade reform increases the income of the poor as a group and that the transition costs are generally small relative to the overall benefits. Nevertheless, there are cases where the short-run effects of liberalization on the poor and others are negative and significant. Although these negative results cannot be discounted, it is important to realize that in many cases they have been affected by the initial patterns of protection.

It is also important to note that most studies assume a short-term perspective in which no changes in investment or the growth path of the economy can occur. But the more important gains from liberalization come from dynamic gains, such as more efficient patterns of investment and technological diffusion. Further, they do not include the effects of complementary policies that facilitate adjustment to the new free-trade equilibrium. For all these reasons, the studies are likely to significantly overstate liberalization's costs and understate its benefits, even for the poor. Over the medium term, changes in investment and economic growth can significantly exceed the negative distributional effects of changes in prices that result from trade liberalization.

Lessons for design of trade reform

A natural question to ask is whether there are ways of liberalizing trade restrictions that might be more friendly to the poor. One first and obvious suggestion is to pay attention to the way liberalization might affect the most vulnerable members of society. In practical terms, this means developing diagnostic tools that can help policymakers identify who the losers from trade liberalization might be. Based on this analysis, compensatory policies can be designed to help the poor to deal with the transition costs of adjustment and to benefit from the new, open trade regime. In addition, trade reform and complementary economic policies can be implemented so as to ease the plight of the poor.

Broad-based liberalization. The importance of broad-based liberalization (that is, of lowering trade barriers across the board) follows from the economy-wide adjustment to trade liberalization. The wider the domain of trade that is being liberalized, the more individual sectors or groups (including the poor) will be able to perceive the benefits of liberalization (not only from cheaper inputs or consumption goods but also from economy-wide effects such as lower transportation costs). In addition, if liberalization is broad-based, the costs of adjustment will be spread more widely among different sectors.

Exchange rate flexibility. Exchange rate flexibility will not only reduce the output costs of terms of trade shocks but also help a country adjust to trade liberalization. The classic policy prescription for substantial trade liberalization under a fixed exchange rate regime is for a onetime devaluation just before, or in conjunction with, reform. If there is nominal wage rigidity (that is, if wages tend not to decrease when the demand for labor decreases), having some exchange rate flexibility, which will dissipate the shock of trade reform throughout the economy, will be better than requiring adjustment to take place entirely through increased unemployment in the most affected industries. This is especially important if the poor depend on these industries.

Complementary reforms. Trade reform cannot succeed in promoting growth in isolation from other reforms. Complementary reforms enhance the flexibility of markets (which reduces the costs of adjustment) and facilitate the creation of markets that will benefit the poor. Some of the more important complementary reforms are discussed below (see Winters, 2000).

- *Infrastructure development.* Better roads and cheaper transportation will give the poor better access to the principal markets for their products and let them benefit from opportunities that might develop as a result of trade liberalization.
- *Development of markets.* Encouraging the development of markets involves their deregulation and the removal of monopolies (such as state trading monopolies) that could adversely affect the poor or prevent them from receiving the benefits of trade liberalization. But perhaps more important for the poor are the technical assistance, extension services in agriculture, and training in up-to-date business practices. that they may need to receive if they are to take advantage of new market opportunities. Developing credit markets is also an important way of facilitating the provision of important inputs to encourage market activities.
- *Labor mobility and training.* Rigidities in the labor market can also make it difficult for the poor to move into other occupations and take advantage of new market opportunities and to minimize the costs of trade liberalization. Worker training and other forms of assistance can also help the poor who lose jobs in sectors that suffer from trade liberalization to find jobs in sectors that benefit from it.

Sequencing and credibility. Although the broad-based liberalization advocated above can bring considerable benefits, it may be necessary to sequence liberalization at different speeds across sectors to ameliorate the costs of adjustment. This may be true for sectors or markets where liberalization has a very large effect on prices or where adjustment is likely to be very difficult and to take a long time. In addition, trade reform may be phased in gradually if people need more time to adjust to the new policy environment. For example, under the North American Free Trade Agreement (NAFTA), the maize sector was liberalized over a much longer period than other sectors because of the importance of maize farming for Mexico's rural poor. An important condition for implementing long adjustment periods for liberalizing sensitive sectors, however, is the credible commitment of the government to trade reform, often enhanced by its entering into international agreements (either regional or multilateral).

Social safety nets. Even the best-designed trade reform will create winners and losers. In order to mitigate the possible adverse effects of transitory, short-term adjustment costs on the poor, developing countries need to have well-functioning social safety nets to ease the tension between implementing trade reforms and alleviating poverty. They also need to quantify the budgetary costs of offsetting some of these adverse effects—this can be done in the context of the participatory process of the poverty reduction strategy papers for countries that have IMF- and World Bank-supported programs. Given the substantial long-term benefits of trade reforms, the absence of appropriate safety-net policies should not unduly delay trade liberalization, because the sequencing and phasing of reforms can be designed to mitigate the transitional costs for the poor.

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